90-624

Supreme Court, U.S.
FILED
OCT 9 1990
JOSEPH F. SPANIOL, JR.
CLERK

No. ________

In the

Supreme Court of the United States

October Term, 1990

EDISON HOMES, INC.,
formerly ARDMOR, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the
United States Court of Appeals for the Eighth Circuit

PETITION FOR A WRIT OF CERTIORARI

MESHBESHER, SINGER & SPENCE, LTD.
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1990 — Bachman Legal Printing, 835 Second Ave. So., Mpls., MN 55402 — (612) 339-9518 ■
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QUESTIONS PRESENTED FOR REVIEW

Should this Court review the Eighth Circuit's decision holding that the Commissioner of Internal Revenue was within its discretion in totally disallowing an addition to the taxpayer - petitioner's bad debt reserve under 26 U.S.C. § 166(f) (1982), repealed 100 Stat. 2361 (1986), and assessing a deficiency because not all of the debts alleged to be bad were proved to qualify for the addition?

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REPORT OF OPINION BELOW

The case is reported below as <u>Edison Homes, Inc. formerly Ardmor, Inc. v. Commissioner of Internal Revenue</u>, 903 F.2d 579 (8th Cir. 1990), decided May 17, 1990, rehearing and rehearing for banc denied July 9, 1990, which is contained in the appendix to this petition.

JURISDICTION

The date of the opinion below was May 17, 1990, and the judgment was corrected nunc pro tunc by order of October 4, 1990. The timely petition for rehearing and rehearing en banc was denied by order of July 9, 1990. The statutory provision believed to confer jurisdiction to review the matter by writ of certiorari is 28 U.S.C. § 1254.

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution:

Amendment V

No person shall be held in answer for a capitol or to otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service, in time of war and public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be witness against himself; nor be deprived of life, liberty, or property without due proces of law; nor shall private property be taken for public use without just compensation.

Internal Revenue Code of 1954:

26 U.S.C. Section 166(c):

Reserve for bad debts.

In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

26 U.S.C. Section 166(f)(1)(A):

Reserve for certain guaranteed debt obligations.

(1) Allowance of deduction. In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) for any taxable year ended after October 21, 1965, a deduction --

(A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business;

(repealed, Pub.L. 9-514, Sec. 805(b), 100 Sat. 2361).

STATEMENT OF THE CASE

Petitioner Edison Homes,Inc. (hereafter Edison) was a dealer in new and used mobile homes, who sold its contracts to General Electric Credit Corporation (hereafter GECC). Edison remained liable for the accounts, in case of default, and Edison's president, Gerald Toberman, personally guaranteed all the accounts.

At the time in question, under 26 U.S.C. §§ 166(c) and 166(f)A, repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, Title VIII, §§ 805(a) and (b), 100 Stat. 2361 (1986), a taxpayer who sold real or personal property could elect to make a "reasonable addition to a reserve for bad debts" arising out of an obligation as a guarantor of debt obligations arising in the normal course

of business, in the Commissioner's discretion. This addition for future bad debts is in lieu of a deduction for past bad debts under 26 U.S.C. § 166(a).

In 1981, with the aid of a CPA, Edison took an addition to its bad debt reserve of $528,024, the total reserve being $774,152, or 3.5% of its outstanding liability to GECC. The addition was prompted by a number of factors, primarily a nation-wide deterioration in the economy with high interest rates and increased unemployment which, in turn, greatly increased Edison's and GECC's defaults and repossessions. Edison figured its total obligation as about $23 million, but since this included some unearned interest the amount actually owing was somewhat less; nevertheless the actual debt was large and many times more than the new bad debt reserve.

The Commissioner found that not all of the transactions by Edison were "sales" of property, even though Edison appeared and was considered the "seller" in all and was liable for all in case of default, because some of the sales were arranged by agents for commissions, which the Commissioner characterized as "brokered" transactions and disallowed. Despite Edison's use of a CPA, to whom Edison supplied the information for its return, the Commissioner found Edison negligent and assessed a negligence penalty. The tax deficiency was assessed at \$251,665, plus a penalty of 5%, or \$12,583, plus 50% of the interest due on \$251,665. This disallowed <u>all</u> transactions, not only the so-called "brokered" sales.

The Tax Court upheld the Commissioner, holding that Petitioner had not

satisfied its burden of proving an abuse of discretion, and the Court of Appeals for the Eighth Circuit affirmed. Edison Homes, Inc. v. Commissioner, 903 F.2d 579 (8th Cir. 1990), rehearing and rehearing en banc denied July 9, 1990. (Appendix A-1 et seq.).

Petitioner contends that the Commissioner clearly abused his discretion by disallowing all transactions even though most, if not all, of those described at trial were ordinary sales which undoubtedly qualified, and on the others Edison and Toberman remained equally liable. This denial of any addition despite the evidence, solely in the Commissioner's discretion, denies due process of law.

REASONS FOR ALLOWING THE WRIT

Petitioner believes the decision of the Court of Appeals (like those of the Commissioner and the Tax Court before it) so far departs from and conflicts with the law as previously set forth by this Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979), that it virtually renders the concept of "discretion" meaningless, thus creating special and important reasons for review, within the meaning of Rule 17.1, Rules of the Supreme Court.

The evidence at trial showed without doubt that: 1) Petitioner was a seller of property, 2) Petitioner had actual bad debts for which it was fully liable in an amount (though not exactly

determined) well above the increased reserve, 3) economic conditions in the pertinent year were genuinely poor and adversely affected Petitioner in a drastic way. Therefore, even if the transactions which were found to be "brokered" rather than "sales" are excluded upon a technical reading of the statute as applicable only to sales, Petitioner's reserve addition was reasonable. (We do not here argue the issue of whether <u>some</u> sales were properly excluded, which involves a narrower question of fact and law, although it is important to recognize that Petitioner was fully liable for the bad debts on <u>all</u> the transactions, and thus the alleged failure of proof as to whether some were "sales" does not

affect Petitioner's actual liability on the debts, nor should it affect the tax consequences).

In Thor Power Tool Co. v. Commissioner, supra, this Court discussed the standards of reasonableness under this statute, and said that where a taxpayer "can point to conditions that will cause future debt collections to be less likely" than in the past, the taxpayer "is entitled to" an addition larger than might otherwise have been permitted. 439 U.S. at 550. In Thor Power Tool the Commissioner's disallowance was upheld because there was no evidence of such changed conditions; here by contrast the changed conditions (and actual bad debts) were undeniably proved.

The decision was based, instead, on the notions that 1) because <u>some</u> of the transactions were not, technically, sales, and 2) because the two types of transactions were not fully segregated and identified, therefore <u>none</u> of the addition would be allowed. This is not an exercise of discretion, but of arbitrariness, presaging anarchy disguised as "discretion." For if this decision stands, the Commissioner's power is inflated to the point where if it finds <u>some</u> defect in the proof as to the type or amount of the transactions, it can ignore all other transactions no matter how well proved.

What is more, the Commissioner not only found a deficiency, but imposed severe penalties which go well beyond

defeating the part of the addition found questionable, well beyond even Petitioner's entitlement to claim actual and proved bad debts, and take his property in the form of greatly increased tax penalty payments without due process. "Due process" cannot have become so threadbare a concept as to be synonymous with the Commissioner's whim, called discretion.

At the very least, Petitioner was entitled to a remand to the Tax Court to resolve any ambiguity that might have remained in the record as to which transactions qualified as sales, and as to the actual, allowable amount of these.

Although the statute in question has been repealed, the case is by no

means moot, for Thor Power Tool, supra, remains as an authoritative discussion of "reasonableness" in the ever-important context of federal taxation, and the opinion of the Eighth Circuit in this case now stands as an inconsistent, confusing and deleterious gloss upon the Thor Power Tool decision, undermining the meaning of the perennially important idea of discretion.

CONCLUSION

For these reasons, petitioner respectfully prays that a writ of certiorari issue to review the decision below.

Respectfully submitted,

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APPENDIX INDEX

United States Court of Appeals
For The Eighth Circuit

No. 89-1708

Edison Homes, Inc., formerly Ardmor, Inc., Appellant, v. Commissioner of Internal Revenue, Appellee.	Appeal from the United States Tax Court

Submitted: February 15, 1990

Filed: May 17, 1990

Before LAY, Chief Judge, BEAM, Circuit Judge and WOODS, District Judge.

BEAM, Circuit Judge.

Edison Homes, Inc., taxpayer, appeals from a judgment entered by the United States Tax Court upholding a

deficiency in its 1981 income tax payments. The Commissioner disallowed taxpayer's deduction of $528,024 for an addition to its bad debt reserve under 26 U.S.C. § 166(f) (1982),[1] and assessed a tax deficiency of $251,665. The Commissioner also assessed Edison Homes with an addition to tax for negligence, pursuant to 26 U.S.C. § 6653(a) (1982). The tax court upheld the Commissioner's determination that taxpayer had not met its burden of proving that the Commissioner's disallowance of the deduction was unreasonable, or that the Commissioner's assessment of a penalty

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*The HONORABLE HENRY WOODS, United States District Judge for the Eastern District of Arkansas.

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as in effect during 1981, the taxable year in question.

for negligence was improper. We affirm.

I. BACKGROUND

Edison Homes, Inc. is a dealer in new and used mobile homes. It began business in 1972, and has since done business under several names: Oronco Estates, Inc.; Ardmor, Inc.; and Edison Homes, Inc. Gerald Toberman has been president of Edison Homes since 1972, and its sole shareholders are his children, Barbara and William.[2]

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[2]Toberman testified that while his business has had three corporate names, it has been incorporated only once in the State of Minnesota, and that Oronco, Ardmor and Edison Homes are "all one and the same." Trial Transcript, at 53, 73. The business also used the name "Toberman Companies," although Toberman Companies was not a separate corporate entity and had no corporate officers. Id. at 80. The name "Toberman Companies" was apparently used in transactions involving used mobile homes. See Edison Homes, Inc. v. Commissioner, 56 T.C.M. (CCH) 203, 204 (1988).

As part of its business of selling new and used mobile homes, Edison Homes financed its sales through General Electric Credit Corporation, GECC. Bythe terms of various agreements, GECC purchased the accounts generated by the sale or lease of a mobile home. In the event of default by the buyer, Edison Homes remained liable to GECC for the account balance, less unearned finance charges. Toberman personally guaranteed all accounts.

Edison Homes based its addition to the bad debt reserve on all outstanding past due accounts with GECC. Edison Homes claims that its recourse liability on these accounts was over $23 million, and the record substantiates this figure. GECC maintains its accounts with Edison Homes under four separate dealer numbers.

Dealer number 7036 showed a balance of $11,817,229.90; number 7025 of $7,688,293; number 7026 of $1,030,658; and number 0315 of $2,716,751.17. These figures, however, include both principal and interest; the amount of principal alone is uncertain.[3] Testimony at trial suggested that the principal due on these dealer numbers was probably about one half of the total balance.

As an accrual basis taxpayer, Edison Homes elected, in its 1981 return, to take a deduction for an

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[3]The amount of principal was established at trial for two of the accounts. Principal for dealer number 7036 amounted to $5,540,883.648 and to $863,163.43 for dealer number 0315. No figures were available for the other two dealer numbers. This distinction is important in determining whether the addition to bad debt reserve was reasonable, because Edison Homes, by agreement with GECC, was liable only for principal. *See infra* note 7.

addition to its bad debt reserve as permitted by section 166(f). Its 1981 return was prepared by Hal Gensler, a CPA and tax preparer with a Minneapolis accounting firm. Gensler prepared the return based upon information supplied to him by Edison Homes. Since 1981 was a poor economic year, with high interest rates and growing unemployment, Edison Homes anticipated an increasing number of defaults and repossessions. It, therefore, calculated an addition to its current bad debt reserve. At the beginning of 1981, the reserve contained $246,128. Edison Homes calculated an addition by taking 3.25% of its total outstanding liability on its accounts with GECC, $23,820.059. This calculation produced a reserve of $774,152. Thus, less the reserve balance at the beginning of 1981, Edison

Homes added $528,024 to its bad debt reserve, and claimed a deduction for that amount.

The Commissioner found that Edison Homes improperly calculated the addition to reserve. The Commissioner found that Edison Homes based its calculations, in part, on its debt obligations to GECC arising from transactions other than the sale of tangible personal property as required by section 166(f)(1)(A), and, denied the deduction in full. The Commissioner also found that Edison Homes had been negligent in preparing its 1981 return. Thus, the Commissioner assessed a deficiency of $251,665, and an addition to tax, as a penalty, of $12,583 (five percent of the deficiency), plus fifty percent of the interest due on $251,665. <u>See</u> 26 U.S.C. § 6653(a)(2).

The case was tried to the tax court on May 21, 1987, and decision was entered on February 3, 1989. The tax court held that Edison Homes failed to meet its heavy burden of proving that the Commissioner had abused his discretion in disallowing the claimed deduction for the bad debt reserve. <u>Edison Homes, Inc. v. Commissioner</u>, 56 T.C.M. (CCH) 203, 207 (1988). Specifically, Edison Homes failed, according to the tax court, to prove that its reserve calculations were based only on debt obligations arising from sales, the tax court made a finding that Edison Homes acted as broker, and not as seller, as to <u>all</u> used mobile homes. <u>Id</u>. Based upon this failure of proof by Edison Homes, the tax court was unable to segregate actual sales from brokered transactions, and thus to determine

whether the calculation was reasonable. Therefore, the tax court could not say that the Commissioner's disallowance was an abuse of discretion. Id. The tax court also held that Edison Homes had been negligent in preparing its 1981 return. Id. at 207-08. Accordingly, the tax court found that the Commissioner properly assessed a penalty for negligence.

II. DISCUSSION

Secion 166 allows a taxpayer to take a deduction for losses incurred because of bad debts. Section 166(a) provides that a taxpayer may take a deduction for a debt which becomes worthless within the taxable year. In the alternative, sections 166(c) and

(f)[4] allow a taxpayer to take a deduction for a reasonable addition to a reserve established to cover future bad debts.[5] The statutory scheme clearly

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[4]Both sections were repealed effective December 31, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, Title VIII, §§ 805(a) and (b), 100 Stat. 2361 (1986).

[5]Section 166(c) provides:

> In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

26 U.S.C. § 166(c).

Section 166(f) is a particular application of section 166(c), providing for a reserve for certain guaranteed debt obligations. Section 166(f) provides:

> (1) Allowance of deduction
>
> In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) for any taxable year ending after October 21, 1965, a deduction--

provides that the deduction for an addition to reserve is taken _in lieu of_ a specific deduction for an actually worthless debt, _see_ _Beneficial Corp. & Subsidiaries v. United States_, 814 F.2d 1570, 1571 (Fed. Cir. 1987), and is, therefore, subject to the discretion of the Commissioner. Since sections 166(c) and (f) allow a deduction for a loss which has not yet occurred, they afford a tax preference to the taxpayer; the taxpayer must otherwise take a deduction only when the loss has actually occurred. _See_ _Thompson v. Commissioner_, 761 F.2d

(Continuation of [5])

> (A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor or debt obligations arising out of the sale by him of real property or tangible personal property . . . in the ordinary course of his trade or business.

26 U.S.C. § 166(f)(1).

259, 261 (6th Cir. 1985). The reserve can only estimate the amount necessary to cover future losses on current debts. See Roth Steel Tube Co. v. Commissioner, 620 F.2d 1176, 1179 (6th Cir. 1980). By choosing the reserve method the taxpayer subjects himself to the discretion of the Commissioner. Beneficial Corp., 814 F.2d at 1573.

The United States Supreme Cou considered section 166(c) in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). In Thor, the Court emphasized the statutory grant of discretion to the Commissioner. The Supreme Court held that the Commissioner's determination of a reasonable addition "must be sustained unless the taxpayer proves that the Commissioner abused his discretion. The taxpayer is said to bear a 'heavy

burden' in this respect. He must show not only that his own computation is reasonable but also that the Commissioner's computation is unreasonable and arbitrary." _Id_. at 548 (footnotes omitted). In effect, the statutory grant of discretion limits judicial review of the Commissioner's determination, _Roth Steel_, 620 F.2d at 1179, and the Commissioner's determination can be found unreasonable only if the taxpayer proves an abuse of discretion. _See_ _Dixie Furniture Co. v. Commissioner_, 390 F.2d 139, 141 (8thCir. 1968); _Beneficial Corp._, 814 F.2d at 1572; _Thompson_, 761 F.2d at 261. Moreover, the focus is not solely on the reasonableness of the taxpayer's calculations. That is, that the taxpayer's calculations are reasonable does not necessarily mean that the

Commissioner's are unreasonable. Malone & Hyde, Inc. v. United States, 568 F.2d 474, 477 (6th Cir. 1978).

We cannot agree with Edison Homes that the Commissioner's disallowance of the deduction in this case was unreasonable. On appeal, Edison Homes argues, essentially, that the Commissioner's calculations were unreasonable because its own were reasonable. Given the economic conditions of 1981, and, in hindsight, its actual losses for 1981, Edison Homes argues that its addition to reserve was more than reasonable.[6] Edison Homes

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[6]In Thor, the Supreme Court defined a "reasonable addition" as "the amount necessary to bring the reserve balance up to the level that can be expected to cover losses properly anticipated on debts outstanding at the end of the tax year." Thor, 439 U.S. at 546.

does not dispute that it bears a heavy burden in proving that the Commissioner abused his discretion. Nor does Edison Homes argue that its addition can be based on obligations other than those arising from the sale of personal property as required by section 166(f)(1)(A). Because Edison Homes has not established that its calculations were based <u>only</u> on debt obligations arising from the sale of mobile homes, it has not proven that its addition was reasonable, let alone that the disallowance was an abuse of discretion by the Commissioner.

As indicated, section 166(f) requires that a reserve be based only on "debt obligations arising out of the <u>sale</u> . . . of . . . tangible personal property." 26 U.S.C. § 166(f)(1)(A) (em-

phasis added). Furthermore, the statute specifically excludes all debt obligations not arising from a sale: "Except as provided in paragraph (1), no deduction shall be allowed to a taxpayer for any addition to a reserve for bad debts which may arise out of his liability as guarantor, endorser, or indemnitor of debt obligations." Id. § 166(f)(2). Evidence presented at trial revealed that the $23 million debt obligation on which Edison Homes based its calculations contained obligations arising from brokered transactions in which Edison Homes was not the seller.

The record contains evidence of several transactions which Edison Homes referred to as "bird-dog" sales. Toberman testified that Edison Homes used "bird-dog" salespeople who would

find a home and a customer, and then involve Edison Homes to arrange financing. Trial Transcript at 69-70. As explained by Toberman: "We worked with several people that would look at homes for us, and if they were able to find a customer, we would just do a joint venture on a sale with them. And they would get a commission from us." Id. at 70. One such transaction, for example, was revealed by the testimony of James Freeman, the regional manager for GECC in Minnesota for part of 1981. Freeman testified that Edison Homes arranged financing through GECC, but that Edison Homes was not actually the seller of the mobile home. In some documents associated with this transaction, Walter and Madelene Kersten were listed as buyers, and Terry and Nancy Scruggs as sellers. Id. at 135-36; exhibit AO. In

others, Ardmor, Inc. was listed as seller. Id. at 139-40. Freeman, however, suggested that listing Ardmor, Inc. as seller did not accurately portray the transaction. He described this transaction as representative of others and stated: "And I became concerned as to using a standard retail contract to handle this type of transaction, versus a brokerage contract. Particularly where the title did not pass to the person signing as seller on the retail installment contract, the title never passed to their hands." Id. at 141. Toberman testified to a similar transaction involving a sale by Ronald and Gayle Myhre to James Smith. Id. at 81-83; exhibit 31. As with the Kersten transaction, the record contains a document, on Toberman Companies letterhead, which states that: "Ardmor,

Inc. is the Agent for placing financing with a lender with respect to the purchase of your mobile home from your dealer." Exhibit 31. Thus, various documents portrayed Ardmor, Inc. acting in different capacities. In the opinion of Freeman, these transactions were simply not sales. Trial Transcript at 142.

Based on the evidence of these and similar transactions, the tax court found that Edison Homes "acted merely as a mortgage broker (and possibly an escrow agent) for the sale of used mobile homes." Edison Homes, 56 T.C.M. (CCH) at 207. Hence, the tax court found that "an unascertainable portion of the $23 million proffered by petitioner as a basis for its dealer reserve represents accounts which did

not arise from sales by petitioner in the ordinary course of its business." Id. Edison Homes does not challenge this finding.

While counsel did state at oral argument that there is no evidence that these transactions were not sales, that assertion cannot refute the specific finding of the tax court. Indeed, it merely misstates the burden of proof. Nor is the argument that these transactions were only a few out of hundreds persuasive. The tax court found that Edison Homes acted as a broker in the case of all used mobile homes, and Edison Homes admitted at oral argument that many more of these transactions could be hidden in the $23 million figure on which it based its calculations. Given that the burden of

proof is on Edison Homes to prove that its calculations were based only on debt obligations arising from sales, and that Edison Homes has failed to do so, we cannot say that the Commissioner's disallowance of the deduction was unreasonable.[7]

Edison Homes also argues that the Commissioner's assessment of a penalty for negligence under section 6653(a) was

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[7]Even if Edison Homes had proved that its calculations were based only on debt obligations arising from sales, it would still be unable to prove that its calculations were reasonable. As the tax court found, the $23 million figure "does not represent petitioner's true potential liability to GECC." Edison Homes, 56 T.C.M. (CCH) at 207. The $23 million figure includes interest charges for which Edison Homes is not liable. As indicated, supra note 3, the record simply does not reveal principal-only figures for all dealer numbers with GECC. While Edison Homes tries to argue that its calculations would be reasonable even if its liability were only half of the $23 million, this argument again misstates the burden of proof.

improper.[8] The tax court found, however, that the deficiency in taxes paid in 1981 was due to negligence. We agree.

Edison Homes also bears the burden of proving that the Commissioner's

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[8]Section 6653(a) provides:

> (1) If any part of any underpayment . . . of any tax imposed . . . is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.
>
> (2) There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601 --
>
> (A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1).

26 U.S.C. § 6653.

assessment of a penalty for negligence was improper. "The Commissioner's assessment of additions to tax, however, are entitled to a presumption of correctness and appellants bear the burden of proving that such determinations were improper." Page v. Commissioner, 823 F.2d 1263, 1272 (8th Cir. 1987), cert. denied, 484 U.S. 1043 (1988). The tax court's finding of negligence is subject to a clearly erroneous standard of review. Forseth v. Commissioner, 845 F.2d 746, 749 (7th Cir. 1988).

Edison Homes argues that it was not negligent because it merely interpreted a "rather obscure provision of law," brief for appellant at 36, differently than did the Commissioner. As the tax court held, however, section 166(f) is unambiguous. Edison Homes, 56 T.C.M.

(CCH) at 206. Section 166(f) clearly requires that any addition to reserve be based only on debt obligations arising from sales. Yet Edison Homes included in its calculations obligations arising from transactions in which it never had or transferred title to the mobile homes involved. We disagree that the law is unsettled as to whether such a transaction could in any way be considered a sale for purposes of section 166(f).

Alternatively, Edison Homes argues that it cannot be negligent because it relied on its accountant to prepare the 1981 return. Its accountant, however, merely calculated the reserve based on figures supplied by Edison Homes. Trial Transcript at 90-91, 95-97. As we held in Page, reliance on legal advice does not constitute proof that the Commis-

sioner's negligence determination was improper. Page, 823 F.2d at 1272. Cf. Scallen v. Commissioner, 877 F.2d 1364, 1371 (8th Cir. 1989) ("A taxpayer may not rely on errors of his tax preparer as a defense to a charge of fraud if the taxpayer failed to provide the preparer with the proper documentation correctly to prepare the return.") Given the state of this record, we can say without difficulty that the Commissioner's assessments for negligence were proper.

III. CONCLUSION

Edison Homes bore a heavy burden in this case to prove that the Commissioner abused his discretion in disallowing the deduction for an addition to reserve. Edison Homes has fallen well short of meeting this burden, for, given the tax court's finding of brokered transac-

tions, Edison Homes is unable to prove even that its own calculations were reasonable, let alone that the Commissioner's were unreasonable. For the reasons stated, the decision of the tax court is affirmed.

A true copy.

Attest:

CLERK, U.S. COURT OF
APPEALS, EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 89-1708

Edison Homes, Inc., formerly Ardmor, Inc.,	*	
Appellant,	*	
vs.	*	Appeal from the United States Tax Court
Commissioner of Internal Revenue,	*	
Appellee.	*	

JUDGMENT

This appeal from the United States District Court was submitted on the record of the district court, briefs of the parties and was argued by counsel.

After consideration, it is ordered and adjudged that the judgment of the district court in this cause is affirmed in accordance with the opinion of this Court.

May 17, 1990

Order entered in accordance with opinion.

/s/ Robert D. St. Vrain

Clerk, U.S. Court of Appeals, Eighth Circuit

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 89-1708

Edison Homes, Inc., formerly Ardmor, Inc., Appellant,	*	
vs.	*	Appeal from the United States Tax Court
Commissioner of Internal Revenue, Appellee.	*	

The first line of the judgment entered May 17, 1990, contained a typographical error and the judgment is corrected to read as follows: "This appeal from the United States Tax Court...."

The Clerk of the United States Tax Court is directed to file the corrected judgment nunc pro tunc May 17, 1990.

October 4, 1990

A true copy.

ATTEST:

Clerk, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 89-1708

Edison Homes, Inc., formerly Ardmor, Inc., Appellant,	*	
vs.	*	Appeal from the United States Tax Court
Commissioner of Internal Revenue, Appellee.	*	

JUDGMENT

Nunc pro tunc May 17, 1990

This appeal from the United States Tax Court was submitted on the record of the tax court, briefs of the parties and was argued by counsel.

After consideration, it is ordered and adjudged that the judgment of the tax court in this cause is affirmed in accordance with the opinion of this court.

October 4, 1990

A true copy.

ATTEST:

CLERK, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT

UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 89-1708

Edison Homes, Inc., formerly Ardmor, Inc., Appellant,	Order Denying Petition For Rehearing and Suggestion For Rehearing En Banc.
vs.	
Commissioner of Internal Revenue, Appellee.	

Appellant's suggestion for rehearing en banc has been considered by the court and is denied by reason of the lack of a majority of the active judges voting to rehear the case en banc.

Petition for rehearing by the panel is also denied.

July 9, 1990

Order entered at the direction of the Court:

/s/ Robert D. St. Vrain

Clerk, U.S. Court of Appeals, Eighth Circuit.

(2)

No. 90-624

In the

Supreme Court of the United States

October Term, 1990

EDISON HOMES, INC.,
formerly ARDMOR, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For A Writ of Certiorari
To The United States Court of Appeals
For The Eighth Circuit

SUPPLEMENTAL APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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UNITED STATES TAX COURT

EDISON HOMES, INC., formerly ARDMOR, INC.,	)
Petitioner,	)
v.	) Docket No. 43399-85
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent.	)

DECISION

Pursuant to the opinion of the Court filed September 15, 1988, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1981 in the amount of $251,665.00;

That there is an addition to the tax pursuant to I.R.C. § 6653(a)(1) due from the petitioner for the taxable year 1981 in the amount of $12,383.00; and

That there is an addition to the tax pursuant to I.R.C. § 6653(a)(2) due from the petitioner for the taxable year 1981 in the amount of 50% of the interest due on $251,665.00.

Judge.

Entered: Feb 3 1989

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T. C. Memo. 1988-441

UNITED STATES TAX COURT

EDISON HOMES, INC. FORMERLY ARDMOR, INC., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 43399-85. Filed September 15, 1988.

James H. Gilbert and Robert M. Spector, for the petitioner.

Gail Gibson amd Gerald W. Leland, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WELLS, Judge: Respondent determined a deficiency of $251,665.00 for petitioner's 1981 taxable year, and an addition to tax of $12,583.00 plus 50 percent of the interest accruing on the deficiency under section 6653(a).[1]

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the taxable year at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

After concessions, the issues remaining for decision are (1) whether petitioner may deduct $528,024 as a reasonable addition to its bad debt reserve and (2) whether petitioner is liable for an addition to tax for negligence under section 6653(a).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits to which reference is made therein are incorporated herein by reference.

Petitioner, Edison Homes, Inc., is a corporation which had its principal place of business in St. Louis Park, Minnesota, when it filed its petition.

During the taxable year at issue, calendar year 1981, petitioner was known as Ardmor, Inc., and was engaged in new and used mobile home sales. Gerald S. Toberman served as petitioner's presi-

dent, and Mr. Toberman's children held all of petitioner's capital stock.

Prior to and during 1981, petitioner entered into a number of agreements with General Electric Credit Corporation ("GECC"). The agreement most pertinent to the instant case was entitled "Mobile Home Time Sales Agreement" (hereinafter the "agrement"). The agreement, dated January 28, 1981, set forth terms for the sale by petitioner of its customer accounts to GECC. The agreement required that all accounts sold to GECC arise "from the bona fide sale or lease and delivery of mobile homes [by petitioner]." The agreement also required petitioner to guarantee payment of the installment obligations of its customers, i.e., the accounts were to be transferred to GECC with recourse. In pertinent part, the agreement stated,

> If any Buyer shall default in payment for any reason, or otherwise defaults or fails to perform any obligation pursuant to his or her Account for any reason, *** then and in any such event, Dealer [petitioner] will promptly pay to GECC, upon demand, any amounts then remaining on any such Account(s) less any unearned finance charge thereon.

Additionally, Mr. Toberman and Nancy I. Toberman guaranteed petitioner's obligations to GECC under the foregoing and other agreements.

In 1981, petitioner conducted business under at least two names, Edison Homes and Toberman Companies. Edison Homes sold mobile homes, while Toberman Companies was involved in the sale of used mobile homes.[2] Petitioner sold accounts generated by both Edison Homes and Toberman Companies to GECC.

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[2]The parties dispute the nature of this involvement, which is discussed later in this opinion.

Periodically, GECC sent petitioner a "Statement of Past Due Accounts," which listed accounts purchased by GECC that were in default. Those statements contained language urging petitioner to make collection efforts, warning that "A past due account is a potential repossession." Petitioner found those notices useful, because it had a relationship with some of the debtors, and could at times procure payment from them. If petitioner's collection efforts failed, GECC would repossess the mobile home that served as collateral for the account. GECC would then send petitioner a document entitled "Account Due for Repurchase" or, alternatively, "Repurchase/Payoff Request." Those documents demanded payment of a "Repurchase Price" which equaled the "Present Balance" of an account less unearned finance charges. During 1981,

GECC sent petitioner notices demanding a total of $146,227.95. As of March 24, 1984, petitioner had received demands for payment of past due accounts totalling $2,001,282.10.

All accounts petitioner sold to GECC were classified under one of four "dealer numbers." According to a summary prepared by GECC, the sum of the "account balances" under dealer number 7036 equaled $11,817,229.90, at the end of 1981. The total amount of past due accounts under dealer numbers 7025, 7026, and 0315 were respectively $7,688,293, $1,030,658, and $2,716,751.17.

The sum of the "principal balances" of the accounts purchased by GECC from petitioner did not equal the foregoing totals for dealer numbers 7036, 7025, 7026 and 0315 because those amounts in-

cluded unearned finance charges. For dealer numbers 7036 and 0315 the principal balances, without unearned interest, equaled respectively $5,540,883.68 and $863,163.42. Principal balances are not available for the two other dealer numbers.

The year 1981 was a period of high interest rates, and unemployment and repossessions increased during the year due to poor economic conditions. James Freeman, a former regional manager of GECC, testified that petitioner had a "problem loan portfolio" in 1981.

In late 1981, petitioner and GECC stopped making payments to one another because of a dispute over what each owed the other. One source of the dispute was a cash reserve held by GECC and funded by petitioner, which was required to pay an amount into the reserve for each

account sold to GECC. GECC charged the reserve with amounts owed by petitioner to GECC pursuant to petitioner's recourse guaranty. GECC ceased providing the notices of past due accounts that had proved helpful in avoiding repossessions. In March of1982, GECC and petitioner terminated their relationship.

Petitioner's accountant computed an addition of $528,024 to bad debt reserve for 1981 in the following manner: From a starting reserve balance of $264,084, he subtracted $17,956 as a charge for specific bad debt losses during 1981, leaving a net balance of $246,128. He then determined a reserve requirement of $774,152 by multiplying outstanding "account balances" of $23,820,059[3] by

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[3]This figure approximates the sum of the "account balances" for dealer numbers 7036, 7025, 7026, and 0315.

3.25 percent. He then subtracted the reserve balance of $246,128 from the reserve requirement of $774,152, resulting in a determination that $528,024 was necessary as an addition to the reserve for 1981.

OPINION

Petitioner relies upon section 166(f)(1)[4] in support of its deduction for

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[4]Section 166(f)(1) supplies authority for "dealer reserves" and states, in pertinent part,

> In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) *** a deduction--(A) for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale <u>by him</u> of *** tangible personal property *** in the ordinary course of his trade or business ***. [Emphasis supplied.]

addition to bad debt reserve. Petitioner contends that certain factors, including poor economic conditions in 1981, justify an addition to its bad debt reserve. Respondent contends that petitioner cannot calculate the addition to its bad debt reserve based upon <u>all</u> accounts it assigned to GECC because some of those accounts did not arise out of sales in the ordinary course of petitioner's business.

We hold for respondent. Petitioner bears the burden of proving its entitlment to the deduction for an addition to

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(footnote continued from previous page)

Section 1.166-10(b), Income Tax Regs., makes the rules applicable to general bad debt reserves under section 166(c) equally applicable to dealer reserves under section 166(f)(1). Both subsections (c) and (f) of section 166 were repealed by the Tax Reform Act of 1986, Pub. L. 99-514, sec. 805(b), 100 Stat. 2361 and bad debt reserves are now available only to certain classes of taxpayers.

its bad debt reserve. Rule 142(a). Further, section 166(f)(1) states that a taxpayer's deduction for a reasonable addition to bad debt reserve shall be allowed "in the discretion of the Secretary." Section 166(c)[5] contains identical language, and the Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 548-549 (1979), construed that language as follows:

> the courts uniformly have held that the Commissioner's determination of a "reasonable" (and hence deductible) addition must be sustained unless the taxpayer proves that the Commissioner abused his discretion. The taxpayer is said to bear a "heavy burden" in this respect. He must show not only that his own computation is reasonable but also that the Commissioner's computation is unreasonable and arbitrary.

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[5]Section 166(c) states, "In lieu of a deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts."

As explained below, petitioner has failed to prove the need for any addition to reserve for 1981.

At the outset, it is helpful to note the nature of a bad debt reserve and distinguish a specific bad debt deduction under section 166(a) from a deduction for a reasonable addition to reserve under either subsections (c) or (f) of section 166. While section 166 (a) permits the deduction of individual debts as they become worthless, under the reserve method of reporting bad debts, a deduction is allowed for a "reasonable addition" to reserve. _Thor Power Tool Co. v. Commissioner_, _supra_ at 547.

In _Thor_, the court defined a "reasonable addition" as "the amount necessary to bring the reserve balance up to the level that can be expected to cover loss-

es properly anticipated on debts outstanding at the end of the tax year." Accordingly, in deciding whether petitioner made a "reasonable addition" to its reserve, it is necessary first to find the amount of "debts outstanding at the end of the tax year." Once that figure is found, the reserve level which will meet anticipated losses and the appropriate addition may be ascertained.

The regulations also define a "reasonable addition" and likewise emphasize the importance of fixing the amount of debts outstanding at year end. The following language applies to reserves under subsections (c) and (f) of section 166:

> What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as

> between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. [Emphasis supplied; sec. 1.166-4(b)(1), Income Tax Regs.]

Petitioner asserts that it had an "exposure" of approximately $23 million in debts on which it was contingently liable to GECC as guarantor at the end of taxable year 1981. Petitioner contends that if all accounts assigned to GECC at that time were to go into default, it would be required to pay that amount to GECC pursuant to its recourse guaranty. Petitioner therefore asserts that it is entitled to a reserve based upon $23 million of guaranteed indebtedness.

We reject the amount of $23 million advanced by petitioner as the amount of

debts outstanding at the end of the taxable year at issue. First, that amount encompasses accounts assigned to GECC which did not arise from sales by petitioner in the ordinary course of business. Section 166(f) is unambiguous. A dealer's reserve for guaranteed accounts must be based solely upon accounts which arise "out of the sale by him of real property or tangible personal property *** in the ordinary course of his trade of business." Sec. 166(f)(1) (A). Further, section 166(f)(2)[6] expressly prohibits guarantor reserves notmeeting the requirements of section 166(f)(1).

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[6]Section 166(f)(2) states,

Except as provided in paragraph (1), no deduction shall be allowed to a tax-payer for any addition to a reserve for bad debts which may arise out of his liability as guarantor, endorser, or indemnitor of debt obligations.

Although petitioner's president, Mr. Toberman, testified that petitioner sold all mobile homes, new and used, which gave rise to the accounts assigned to GECC, that testimony is at odds with documentary evidence in the record and the testimony of other witnesses, notably Mr. Freeman, GECC's regional manager in 1981. The record contains a file which documents the sale of a mobile home by Terry and Nancy Scruggs to Walter and Madeline Kersten. The file contains a "Statement of Credit Determination" which shows that a division of petitioner, Toberman Companies, submitted a credit application to GECC on behalf of the Kerstens. A "Statement of Sale" and a cancelled check show that Toberman Companies then obtained loan proceeds, paid off an existing encumbrance against the home, retained a "mortgage placement fee," and remitted

the balance to a dealer representing the Scruggs, the actual sellers of the home.[7] Although petitioner was listed as "seller" on the conditional sales agreement, the foregoing documents make it certain to us that petitioner was not the actual seller of the used home and that the agreement listed petitioner as seller only in order to facilitate its assignment to GECC. In fact, the file also contains a document, signed by the Kerstens, which plainly states: [Petitioner] is the Agent for placing financing with a lender with respect to the purchase of your mobile home from your dealer." In addition, Mr. Freeman tes-

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[7]It is unclear from the record whether Toberman Companies paid off the pre-existing lien after obtaining loan proceeds from GECC or GECC itself directly paid off the lien, as suggested by Mr. Toberman. In either case, Toberman Companies was not the actual seller of the unit and retained only the "mortgage placement fee."

tified to petitioner's "brokerage accounts," stating that he directed petitioner to cease the practice in "late '81." Mr. Toberman himself stated "We also brokered used homes." Mr. Toberman later attempted to "correct" this statement at the urging of his counsel by stating that petitioner bought used mobile homes for resale, but we find Mr. Toberman's first statement more credible. Based upon the foregoing, we find that petitioner acted merely as a mortgage broker (and possibly an escrow agent) for the sale of used mobile homes.

We have examined the record and are unable to determine which of the accounts sold to GECC arose from mobile home sales by petitioner. We note that both "brokered" and bona fide accounts were classified under dealer number 7036.

Thus, the parties did not classify "brokered" accounts under certain dealer numbers, and we are unable to segregate the accounts in such a manner.

We therefore find that an unascertainable portion of the $23 million proffered by petitioner as a basis for its dealer reserve represents accounts which did not arise from sales by petitioner in the ordinary course of its business. Such portion cannot serve as the basis for petitioner's dealer's reserve. Sec. 166(f)(1)(A).

The second reason that we reject the $23 million advanced by petitioner as a basis for its reserve is that the amount does not represent petitioner's true potential liability to GECC as of the end of the taxable year at issue. Rather, the record discloses that unearned interest on assigned accounts is included

in the $23 million total. The total of $23 million is based upon the presupposition that all accounts will be paid over their full term. Although petitioner's accountant quoted petitioner's "outstanding potential liability" as of the end of 1981 at $23,820,059, the record discloses that petitioner's actual exposure at that time did not include unearned interest and was, therefore, much less than that amount. The "Mobile Home Time Sales Agreement" of January 28, 1981, requires petitioner to pay "any amounts then remaining on such Account(s) less any unearned finance charge thereon." None of the agreements in evidence suggests that petitioner obligated itself to pay GECC principal <u>and</u> unearned interest following a buyer's default.

According to Mr. Freeman, petition-

er's actual exposure at the end of 1981 was probably one-half of the $23 million advanced by petitioner as its total liability. Further, the accounting summary produced by GECC to support $23 million as petitioner's total liability shows that "principal balances" of the assigned accounts equal approximately one half of the "account balances" upon which petitioner relies. Finally, Mr. Freeman's estimate of petitioner's exposure finds further support in a set of "Account Due for Repurchase" notices sent by GECC to petitioner. Those notices demand payment from petitioner of a "Repurchase Price" which roughly approximates one half of a stated "Present Balance."[8]

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[8]Even the sum of "principal balances" due on the accounts would not accurately reflect petitioner's exposure, because after the repurchase of collateral from GECC pursuant to the recourse guaranty, petitioner would resell the collateral for some recovery.

Here, petitioner has failed to sustain his "heavy burden." Without providing us with the amount of outstanding liability that can serve as the basis for its reserve, we are unable to find what, if any, addition to reserve would be "reasonable." Petitioner's accountant testified to an opening reserve balance of $264,084. He also testified to charges against the reserve of $17,956 for 1981. Thus, even assuming no credits to the reserve for recoveries of accounts previously written off, petitioner was left with a reserve of $246,128 at year end. As we stated in Handelman v. Commissioner, 36 T.C. 560, 565 (1961), "The ultimate question is whether the credit balance in the reserve is adequate to cover such expected losses." In this case, we can neither say that the reserve balance was insuffi-

cient nor that respondent's determination that it was sufficient was unreasonable. Thus, we hold that petitioner has not shown it is entitled to deduct the addition to its reserve in the amount of $528,024. Rule 142(a); Thor Power Tool Co. v. Commissioner, supra at 549.[9]

Petitioner bears the burden of proving that an addition to tax under section 6653(a) is not warranted. Bixby v.

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[9]In light of our finding that petitioner has failed to prove the amount of outstanding debt to serve as the proper basis for a reserve, it is unnecessary to decide whether the 3.25 percent loss percentage used by petitioner is supported by the record. Further, we need not discuss whether Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), 125 F.2d 977 (6th Cir. 1942), requires that a loss percentage be determined by averaging petitioner's loss experience over a six-year period or whether Thompson v. Commissioner, 761 F.2d 259 (6th Cir. 1985), or other authority cited by petitioner justifies a departure from the Black Motor computation, which has been granted a presumption of correctness by the Supreme Court. Thor Power Tool Co. v. Commissioner, supra at 550.

<u>Commissioner</u>, 58 T.C. 757, 791-792 (1972); Rule 142(a). Petitioner argues that it relied upon the advice of its accountant in reporting the deduction for addition to bad debt reserve, citing <u>Kozikowski v. Commissioner</u>, T.C. Memo. 1986-364, and other cases. However, reliance upon expert advice will not exculpate a taxpayer which supplies its return preparer with incomplete or inaccurate information. <u>Lester Lumber Co. v. Commissioner</u>, 14 T.C. 255, 263 (1950). In the present case, petitioner supplied its accountant with the total sum of "account balances," which included balances for acocunts not arising from sales by petitioner. The accounts which did not arise from sales by petitioner should not have been considered in computing a reserve requirement. Sec. 166 (f)(1)(A).

Petitioner further points to the lack of "settled law" in the area. Yet, section 166(f)(1)(A) clearly states which guaranteed debts qualify for reserve treatment. In ignoring that language, petitioner failed to exercise "due care." Neely v. Commissioner, 85 T.C. 934, 947 (1985). We therefore hold that petitioner is liable for an addition to tax under section 6653(a).

Because of concessions and to reflect the foregoing,

Decision will be entered

Under Rule 155.